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WEEKLY COMMENT: FRIDAY 15 NOVEMBER 2013

1. On 7 November 2013 the Government released *Black hole R&D expenditure – A government discussion document* ("the discussion document"). It contains useful and important proposals to better align expenditure on R&D with the tax depreciation rules. The discussion document is broadly divided into three parts:

   (a) Identification of the non-deductible expenditure that should be deductible;

   (b) Policy options for the tax deductibility of capitalised development expenditure incurred in devising successful inventions; and

   (c) Policy and other issues relating to allowing tax deductions for capitalised development expenditure incurred on derecognised intangible assets.

Identifying black hole expenditure

2. "Black hole" expenditure is business expenditure that is not immediately deductible for tax purposes and also does not form part of the cost of a depreciable asset for tax purposes, and therefore cannot be deducted over time as depreciation.

3. According to the discussion document, the potential for there to be black hole expenditure only exists after costs have been capitalised for accounting purposes. Up to the point at which costs are capitalised under accounting rules, s. DB 34 of the *Income Tax Act 2007* allows a deduction for all expenditure that is expensed under paragraph 68(a) of NZ IAS 38 *Intangible Assets*.

4. Under NZ IAS 38, expenditure on an intangible asset is expensed for accounting purposes until the asset recognition criteria are met. These criteria are listed under the heading of "development phase" in paragraph 57 of NZ IAS 38. NZ IAS 38 prohibits an intangible asset from being recognised during the "research phase" which precedes the development phase. The Government's view stated in paragraph 2.24 of the discussion document is that "the intangible asset recognition criteria seem quite a high bar to satisfy, which suggests that the vast majority of R&D expenditure is already immediately deductible".

5. The four issues identified, following capitalisation for accounting purposes, that could give rise to non-deductibility for tax purposes are:

   (a) The depreciable expenditure does not include all of the capitalised expenditure: according to the Commissioner's Interpretation Statement "Income tax treatment of New Zealand patents", *Tax Information Bulletin* Vol. 18, No. 7 (August 2006), depreciable patent costs (which are limited to the administrative and legal fees incurred in the patent process, and capitalised development expenditure relating to an invention that is the subject of a patent (or patent application) is not part of the depreciable cost; and it is likely that the depreciable costs of plant variety rights would be interpreted in the same way;

(b) The capitalised asset does not meet the tax requirements for "depreciable intangible property": which are that the intangible asset must be listed in Schedule 14 and it must have a finite useful life that can be estimated with a reasonable degree of certainty on the date of its creation or acquisition;

(c) In relation to capitalised software development costs, the intangible asset listed in Schedule 14 as "the copyright in software" arguably has no cost when a taxpayer has self-developed software for which the copyright has arisen by operation of law, without any registration process, or fee paid; on that basis, the depreciable cost of self-developed software is arguably zero (although the Government recognises that this is not in accordance with the policy intent of the Commissioner's 1993 policy statement in the Appendix to *Tax Information Bulletin* Vol. 4, No. 10 (May 1993) and most taxpayers have been depreciating all of their capitalised self-development software costs);

(d) The asset is derecognised for accounting purposes before meeting the requirements to be a depreciable asset for tax purposes.

6. There is a useful diagram on page 7 of the discussion document showing the black hole expenditure in relation to both a successful and an unsuccessful patent.

7. One aspect the Government has concerns about is the potential mismatch if black hole R&D expenditure is made deductible, while the corresponding "black hole income" derived upon sale of the relevant intangible asset remains not taxable. It is noted that income from royalties or from the sale of patent rights or patent applications is currently taxable.

Successful patents and plant variety rights

8. The problem of depreciable expenditure not including all of the capitalised expenditure is to be remedied with respect to successful patents and plant variety rights. However, it is probable that only expenditure incurred on or after 7 November 2013 – the date on which the discussion document was released – can be depreciated – see paragraph 10 below. The Government proposes making it clear that:

(a) The depreciable cost of a patent application and a patent expressly includes capitalised development expenditure incurred (from 7 November 2013 onwards, based on the government's preferred option) in connection with devising the invention; and

(b) Capitalised development expenditure (incurred from 7 November 2013 onwards, based on the government's preferred option) that relates to a plant variety that is the subject of plant variety rights will be depreciable.

9. The Government's view is that this treatment is appropriate if the residual value of know-how at the end of the life of the patent will be nil, and the views of submitters have been requested regarding whether this approximates to commercial reality.

10. The Government's preferred policy option ("option 1") is to target new R&D expenditure only. This would mean that only development expenditure incurred from the date of release of the discussion document – 7 November 2013 – that is capitalised, can be depreciated for tax purposes.

11. Two other options ("options 2 and 3") are also discussed:

    (a) Option 2 involves allowing depreciation deductions for all capitalised development expenditure, whenever incurred, for new assets created from the date of release of the discussion document – 7 November 2013; and

    (b) Option 3 involves allowing depreciation deductions for all capitalised development expenditure for all assets – i.e. for existing, as well as for new, assets; for existing intangible assets, the depreciation deductions would be based on the entire legal life (both before and after the new rule comes into effect), so that only a portion of the capitalised expenditure would end up being deducted: this is explained by way of an example in paragraph 3.11 on page 12 of the discussion document.

12. Options 2 and 3 are not preferred because of the fiscal cost, and also apparently because of:

    (a) The problems that would arise due to having to distinguish between assets capitalised before and after the start date for the new rules; and

    (b) The potentially unequal treatment of an asset with a legal life that is about to expire when the rules come into effect, and an asset with a legal life that has already just expired at that time.

Self-developed software

13. With respect to self-developed software, the Government proposes ratifying the prevalent treatment by most taxpayers by clarifying that capitalised expenditure is depreciable. This amendment is to be made retrospective to the statutory time-bar.

Assets that are not depreciable intangible property

14. It is stated in paragraph 3.19 on page 13 of the discussion document that:

    " … the Government considers it would not be appropriate to allow depreciation deductions for capitalised expenditure on intangible assets that are not currently listed in schedule 14, as it has not been established that these assets have finite useful lives that can be estimated with a reasonable degree of certainty. New intangible assets can, however, be considered for inclusion in schedule 14 on a case-by-case basis. In deciding whether a new intangible asset should be added to schedule 14, a further relevant consideration is whether there is a low risk of the asset being used in tax avoidance schemes if it is made depreciable."

15. The Government's concerns as expressed in the discussion document are three-fold:

    (a) Firstly, the Government is clearly concerned about allowing deductions for assets that may not in fact depreciate in value over time;

    (b) Secondly, where such assets do in fact become useless, the Government is concerned that allowing a deduction upon disposal would amount to allowing a deduction for a capital loss;

    (c) Thirdly, the tax avoidance arrangement in *Ben Nevis Forestry Ventures Ltd v C of IR* (2009) 24 NZTC 23,188 (SC) concerned depreciable intangible property, hence, it would appear, the need to consider whether any new intangible asset could be used in a tax avoidance scheme.

16. Nevertheless, the Government has invited submissions on how capitalised development expenditure that has given rise to an intangible asset with an indefinite useful life should be dealt with.

Treatment of unsuccessful capitalised development expenditure

17. For accounting purposes, unsuccessful capitalised development expenditure is dealt with in paragraph 112 of NZ IAS 38, which provides that an intangible asset shall be derecognised:

    (a) On disposal; or

    (b) When no future economic benefits are expected from its use or disposal.

18. Black hole expenditure arises when an intangible asset is derecognised before it meets the requirements to be a depreciable asset for tax purposes.

19. The Government's view is that unsuccessful expenditure should be tax deductible if it would have led to a depreciable asset, but not otherwise. For this purpose, the government proposes an intention test, "even though this may create practical difficulties as intention is often difficult to prove or disprove" (paragraph 4.22). It is stated further at paragraph 4.24 of the discussion document that:

    " … as a general tax principle, the classification of a particular expense as being of a capital nature is not based on whether it actually produces an enduring benefit but, rather, on whether the expense was intended to produce an enduring benefit."

20. The Government proposes allowing a person a tax deduction for capitalised development expenditure they have incurred if the following three conditions are met:

    (a) The intangible asset to which the expenditure relates has been *derecognised* under the accounting rules (other than due to its disposal) before it is used or available for use:

    (i) In deriving income; or

    (ii) In carrying on a business for the purpose of deriving income.

    (b) The person intended that the expenditure would lead to an item of "depreciable intangible property" (that is, an asset listed in schedule 14 of the *Income Tax Act 2007*) of the person.

    (c) No deduction has been allowed for the expenditure under any other provision.

21. The question of whether a deduction will be allowed only for "new" capitalised development expenditure – incurred from the date of release of the discussion document (7 November 2013) – or for all capitalised development expenditure, is to be determined based on the option adopted for successful capitalised development expenditure.

22. The Government has proposed allowing an immediate deduction for the whole of the capital development expenditure that qualifies for the deduction, rather than a piecemeal deduction spread over the notional life of the asset that would have been created if the expenditure had been successful. This is on the basis that:

    (a) Allowing an immediate deduction is consistent with the current treatment for depreciable assets that are written off;

    (b) Requiring the deduction to be spread might create an incentive to develop a depreciable asset that could then be written off; and

(c) Solutions implemented for other black hole expenditure problems have involved allowing an immediate deduction.

Claw-back

23. The Government has proposed that if a failed asset from an abandoned R&D project (which has had capitalised development expenditure deducted):

(a) Becomes useful: the capitalised development expenditure previously allowed as a deduction:

(i) Would be clawed back as income; and

(ii) Could be depreciated over the estimated useful life of the asset, if the asset is a depreciable asset.

(b) Is sold:

(i) The capitalised development expenditure previously allowed as a deduction (or the sale proceeds, if this amount is lower) should also be clawed back; and

(ii) The entire sales proceeds would be treated as assessable income if the sale of the failed asset would otherwise give rise to assessable income (which is the present treatment in such cases).

Risks relating to deductions for unsuccessful capitalised development expenditure

24. The Government has identified the following risks:

(a) Risk of residual know-how: when an R&D project is abandoned after the point of intangible asset recognition for account ting but before a depreciable intangible asset is created, there is a question around how inland Revenue would know the taxpayer no longer has valuable know-how;

(b) Perverse incentive for early abandonment of marginal projects: there may be an incentive for taxpayers to abandon projects earlier than they would otherwise, because of the tax deduction available;

(c) Risk of non-R&D expenditure being labelled as R&D: the Government recognises this to be a major risk of providing tax incentives for R&D, however, in the case of deductions (as opposed to tax credits) the re-labelled expenditure, if any, is likely to tax deductible on its own in most cases;

(d) Risk of breaking down R&D projects: there could be an incentive to divide up an R&D project into smaller portions and claim deductions for failed aspects of what is really a single project.

25. Submissions have been invited in all of these points. Submissions close on 17 December 2013.

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